
FRBSF WEEKLY LETTER

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Japan's Financial Reform

The financial reform process referred to as "de-regulation" in the United States is also occurring in Japan, where it is called "financial liberalization." Both processes share certain catalysts and objectives, but the cultural, institutional, and economic environments of the two countries ensure significant differences in their respective approaches to financial reform. This *Letter* outlines the liberalization process in Japan and discusses the importance of liberalization from the U.S. perspective.

Japanese financial liberalization

Financial liberalization in Japan is focused on restructuring the domestic and international flow of funds between lenders and borrowers to satisfy better the new requirements of economic growth in the 1980s. Specific reforms, which officially started in 1976, have been designed to increase the role of market forces by relaxing interest rate constraints and broadening portfolio opportunities for market participants; expanding existing securities markets and developing new securities markets for both private and public debt; increasing capital flows in and out of Japan; widening access by foreign financial institutions to Japan's financial system; and "internationalizing" the yen with the objective of increasing Japan's role in the international financial system.

Japan's financial system prior to liberalization was highly constrained by regulation and administrative guidance from the Ministry of Finance (MOF) and the Bank of Japan (BOJ). Banks and other financial institutions were subject to portfolio restrictions, interest rate constraints on deposit and lending activity, and restrictions on international transactions. Securities markets were undeveloped since government deficits were small and corporate borrowers relied almost exclusively on large banks for short- and long-term funding. The domestic financial system was internationally isolated via a complex set of capital controls, restrictions on Euro-yen activity, and limited access by foreign financial institutions.

The objectives of this highly structured, segmented, and regulated system were to support export-led economic growth, industrialization,

and high personal savings, and to provide a simple conduit for transferring the large surplus of funds in the personal sector to the large deficit in the corporate sector.

The objectives were well-served by the regulatory system until the first oil-price shock of 1973-74, which marked the end of rapid economic growth in Japan. Real GNP growth declined from a 10 percent level to the present range of 3 to 5 percent. The impact of reduced economic growth on the flow of funds must be judged the most important catalyst for financial liberalization for three reasons.

First, the slowdown increased the size of the public sector deficit significantly. Public sector deficits had averaged about 2 percent of GNP prior to 1973, but had quickly increased to over 7 percent of GNP by 1975. Rather than sell the increasing volume of government debt on the open market, the MOF placed the debt directly with a "captive" syndicate of banks and other institutions that were required to purchase the debt at below-market rates and to hold it for as long as one year. Syndicate members did not resist the procedure prior to 1975 largely because the amount of debt was small. Also, the BOJ was willing to repurchase the debt from banks at prices that guaranteed no capital loss, and the MOF allowed securities companies to use the debt to support a repurchase, or "gensaki," market as it is called in Japan. After 1975, when the size of the debt rose, the MOF met with increasing market resistance and was forced to make a number of concessions to market forces, which officially started the liberalization process.

Second, slower economic growth with concomitant reductions in profit opportunities and in the need to expand plant and equipment meant that the corporate sector deficit declined significantly. Corporate sector deficits have averaged about 6 percent of GNP prior to 1973; they declined to less than 4 percent of GNP after 1975. The banking system's market share dropped as a result of reduced corporate demand for credit. And corporations became more aware of alternative sources of funding, particularly the management of financial assets as a new source of profit. Banks thus became advocates of increased flexibility as a means of

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re-establishing and increasing their market share, and corporations became advocates of more funding sources and more market-sensitive financial assets.

Third, the household sector also brought pressure to liberalize the financial system. Prior to 1974, households' alternatives for investing their savings were restricted to a narrow set of regulated financial assets. For a variety of reasons, they did not use the financial system as a major source of borrowing. Slower economic growth, however, increased household awareness of the burdens of being limited to investing wealth in regulated, relatively low-yielding investments. In addition, the changing age distribution of the population toward older individuals increased the need to manage financial assets for retirement.

Other forces also were important in bringing pressure for liberalizing Japan's financial structure. The shift from a fixed to a floating exchange rate system after 1973 brought pressure to end restrictions on short- and long-term capital movements in and out of Japan. In addition, deposit rate ceilings became seriously binding on the occasions when secondary market rates exceeded regulated rates. As well, advances in computer technology increased the ability of financial institutions to innovate and introduce new services (such as cash dispensers and credit cards) and new financial assets (such as combined demand/time deposit accounts and government bond mutual fund accounts).

Pressure from *outside* Japan recently has become an important impetus to further liberalization. Japan has been encouraged to open its markets to international competition, including its financial system to access by foreign financial institutions, and to take steps that will make the yen an international currency like the dollar—one widely used to make international payments and which is attractive as an investment vehicle for foreigners.

What has been accomplished

The financial reforms in Japan have been directed toward four areas: intermediation finance, the government bond market, the short-term money market, and international finance.

In intermediation finance, banks have been authorized to issue large CDs paying interest rates

that are responsive to market rates, to offer new deposit accounts that earn higher regulated rates of return, and to increase consumer lending. Securities companies have been authorized to issue bond fund accounts with limited transaction features. Deposits, with the exception of large CDs, are still subject to interest rate ceilings. However, the regulators have been willing to adjust ceilings more frequently to minimize the spread between market and regulated interest rates. Most of the controls over lending rates previously enforced by the regulators have been removed.

In the government bond market, the MOF has permitted syndicate members to sell government debt 100 days after purchase, offered medium-term government bonds publicly (at market rates), allowed banks to make over-the-counter sales of new government issues, and narrowed the spread between the market and issue rate on securities sold to syndicate members. Overall, the new issue market for government bonds has become sensitive to market forces.

In short-term securities markets, transactions in the government bond repurchase market, or *gensaki* trade, have expanded greatly since the market was officially recognized in 1976. The volume of CDs has grown quickly since their authorization in 1979. Despite the lack of a new-issue Treasury bill market, the shortened maturity of existing long-term debt has *de facto* established a short-term government securities market. Finally, regulators have expanded participation in the interbank money market and largely freed it of interest rate restrictions.

In international finance, liberalization has increased access by foreign financial institutions and relaxed or eliminated most of the restrictions over capital flows. The 1980 amendments to the Foreign Exchange and Foreign Trade Control Law officially established the principle that capital flows in and out of Japan are not to be regulated, and that controls will only be used in an emergency to prevent disruptive exchange rate fluctuations. In addition, the environment for an expanded Euro-yen market has been improved by allowing nonresidents to issue Euro-yen bonds, by removing the withholding tax on non-residents holding Euro-yen bonds issued by Japanese residents, and by allowing Japanese banks and foreign banks to issue Euro-yen CDs.

Ten years have passed since the initial efforts at financial reform in Japan, and considerable progress has been made. Additional reforms, such as establishing a bankers' acceptance market and a bond futures market, and removing interest rate ceilings on large deposits, are planned for the near future.

Importance from the U.S. perspective

Financial reform in Japan has recently become an issue in discussions between the U.S. and Japan over international trade issues. In the May 1984 policy discussions between the U.S. Treasury and the MOF, the U.S. encouraged Japan to increase the pace of financial liberalization, especially with regard to increasing access for foreign financial institutions to Japan's domestic markets, and to take steps to increase the use of the yen in international trade and finance. The U.S. expected a faster pace of liberalization to increase the world demand for the yen, and thus contribute to a lower yen/dollar exchange rate as well as an increase in U.S. exports of financial services to Japan (by making Japanese financial markets more accessible to U.S. institutions).

Some economists argue it is not certain how the yen/dollar exchange rate will be influenced by the liberalization process in Japan. One study, for example, concluded that some of the proposals advanced for opening up the Japanese financial system, if enacted, would increase the exchange value of the yen while others would decrease it. Other studies have reached a similar conclusion. It is by no means clear, therefore, that the dollar's rise against the yen and other currencies would be offset significantly by a faster pace of Japanese liberalization. Instead, the effects of high U.S. interest rates and federal deficits will continue to dominate in determining the yen/dollar exchange rate.

Neither is it clear that giving U.S. financial institutions greater access to Japanese markets will mean a greater export of U.S. financial services to Japan. Japan has changed its Banking Law to incorporate the principle that domestic and foreign banks are to be treated equally. However, this has meant that foreign banks now face competition in some areas

for which they previously held a privileged position. The case of impact loans is a good example. An impact loan is a loan to a Japanese resident denominated in a foreign currency, which, until recently, only foreign banks could make. As a result of liberalization, Japanese banks now compete aggressively and may have an advantage in being more familiar with the needs of Japanese customers.

Despite these reservations, it is still true that there are significant benefits to the U.S. from Japan's liberalization process. The increased use of the yen in international trade and finance will increase Japan's role to a level commensurate with its economic size. It also will make it more likely that the U.S. and Japan will play a joint role in providing a financial infrastructure for the Pacific Basin region, a region that shows signs of being the world's major growth center in coming decades.

Conclusion

There are important benefits to the Japanese from a more liberalized financial system. The pre-liberalized financial system served Japan's needs for the three decades after World War II. It was structurally simple and provided an excellent conduit for the transfer of sizeable household savings to large corporations in support of export-led economic growth and industrialization. Since then, Japan has become a major industrialized economy that must face oil-price shocks, slower economic growth, changing flows of funds, and increased financial integration with the rest of the industrialized world. Japanese regulators have recognized the incompatibility of the previously constrained financial system with the new economic environment, and have made progress toward creating a freer, more competitive, and open financial system.

Despite the uncertainty over the beneficial effects of Japanese liberalization on the yen/dollar exchange rate and the U.S. balance on goods and services, there is no question that the U.S. ultimately stands to gain from a continuation of the liberalization process.

Thomas F. Cargill

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 04/24/85	Change from 04/17/85	Change from 04/25/84 Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	189,617	— 13	11,140	6.2
Loans and Leases ^{1 6}	171,694	— 265	12,664	7.9
Commercial and Industrial	51,982	— 259	3,888	8.0
Real estate	62,815	— 16	2,849	4.7
Loans to Individuals	33,767	186	6,115	22.1
Leases	5,350	3	356	7.1
U.S. Treasury and Agency Securities ²	11,005	261	— 1,067	— 8.8
Other Securities ²	6,918	— 9	— 456	— 6.1
Total Deposits	193,273	—4,423	8,677	4.7
Demand Deposits	44,103	—3,244	954	2.2
Demand Deposits Adjusted ³	30,149	—1,118	1,297	4.4
Other Transaction Balances ⁴	13,583	— 949	1,456	12.0
Total Non-Transaction Balances ⁶	135,587	— 230	6,267	4.8
Money Market Deposit Accounts—Total	43,310	— 281	3,693	9.3
Time Deposits in Amounts of \$100,000 or more	38,699	69	714	1.8
Other Liabilities for Borrowed Money ⁵	22,954	2,157	1,717	8.0
Two Week Averages of Daily Figures	Period ended 04/22/85	Period ended 04/08/85		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	88	— 32		
Borrowings	24	123		
Net free reserves (+)/Net borrowed(—)	64	— 155		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change